

STATE OF ALABAMA  
DEPARTMENT OF REVENUE,

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STATE OF ALABAMA  
DEPARTMENT OF REVENUE  
ADMINISTRATIVE LAW DIVISION

§

v.

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DOCKET NO. INC. 86-136

MULTIONICS, INC.  
4115 Commerce Avenue  
Fairfield, AL 35064,

§

§

Taxpayer.

§

ORDER

This matter involves a disputed preliminary assessment of income tax entered by the Revenue Department (Department) against Multionics, Inc. (Taxpayer) for the fiscal year ending 6/30/85. An initial hearing was held on December 9, 1986, with a subsequent hearing on April 29, 1987. Assistant counsel Mark Griffin represented the Department at both hearings. CPA Grant McDonald represented the Taxpayer at the April 29, 1987 hearing. Based on the evidence taken at both hearings, the following findings of fact and conclusions of law are hereby made and entered.

FINDINGS OF FACT

The primary issue in this case is the general applicability of the tax benefit rule in Alabama. Subsequent to the December 9, 1986 hearing, an order was entered by the Administrative Law Division holding that the tax benefit rule should be recognized by the Department. However, insufficient evidence was produced at the hearing from which it could be determined whether the rule should be applied in the instant case.

The purpose of the April 29, 1987 hearing was to allow the

Taxpayer an opportunity to establish that various deductions for depreciation and insurance premiums taken in prior years had not resulted in a tax benefit in those years. If no tax benefit had been received, then under the tax benefit rule, certain income received (a premium refund and gain from the sale of the depreciated property) in the tax year in question relative to said deductions would not constitute taxable income to the Taxpayer.

At the April 29, 1987 hearing, the Department did not dispute the Taxpayer's argument that no tax benefit had been received from the prior year deductions. However, the Department did contest the determination that the tax benefit rule was applicable to the instant situation. That is, the Department recognizes the tax benefit rule, but contends that it should be limited to tax refund situations only.

#### CONCLUSIONS OF LAW

The Department's argument that the tax benefit rule should apply to tax refunds only is based on the fact that the only Alabama appellate court decision involving the rule, State v. Edelman, 114 So.2d 261 (1958), involved a tax refund. However, it is clear from a review of the history of the rule on the federal level, and from the language of the Edelman decision itself, that the rule should not be restricted in application to only tax refund situations.

Succinctly stated, the tax benefit rule provides that the

receipt or recovery of an item previously deducted must be included as income, although technically the amount may not come within the strict definition of gross income (rule of inclusion). Conversely, that portion of the recovery which did not result in prior year tax benefit should be excluded from gross income (rule of exclusion).

The rule has a case law beginning, and, despite its partial recognition through the enactment of 26 U.S.C. 111 in 1942 relative to bad debts, taxes and delinquent amounts, remains extra-statutory in nature and encompasses many items outside of the literal scope of the statute. As stated in Home Mutual Insurance Company v. C.I.R., 639 F.2d 333 (1980):

The tax benefit rule is a well established judge-made rule that despite partial codification in §111 remains substantially extra-statutory in nature and affects a taxpayer's taxable income beyond the literal meaning of the Code itself.

In short, the inclusionary aspect of the rule, which is based entirely on case law, "recognizes the 'recovery' in the current year of taxable income earned in an earlier year but offset by the item deducted". Because such recoveries are reportable due to the existence of previous deductions, taxpayers have successfully argued that the recoveries should be included in income only to the extent that the earlier deduction had in fact served to reduce its taxable income in the year in which the deduction was taken. This exclusionary aspect of the tax benefit rule was not conclusively accepted until 1942, when Congress enacted the statutory predecessor to current §111. Although §111 expressly provides for such exclusion only for the recover of previously deducted bad debts, taxes, and delinquency amounts, it is well settled that this aspect of the tax benefit extends beyond the literal terms of the statute. Thus, although the exclusionary part of the tax benefit rule finds a statutory anchor, the entire rule remains in essence an extra-statutory judicial rule permitting retroactive

adjustments so that some transactions substantially altered in years subsequent to the original accounting period may be taxed virtually as though the entire transaction had occurred in one accounting period. (emphasis added)

Alabama has not statute comparable to §111. However, the Edelman case clearly establishes that the tax benefit rule is valid in Alabama. The Supreme Court began the Edelman case by recognizing the inclusionary aspects of the rule.

In a strict sense income has been considered gain derived either from capital or labor, or from both combined, or from the sale or exchange of property.

The recovery of a debt previously charged off as worthless, the refund or abatement of a tax, the recoupment of a loss, the rebate or cancellation of an expense, and similar adjustments affecting items deducted in prior years are not in this strict sense a part of income.

Nevertheless, such recoveries or cancellations are as a general rule said to be subject to income tax. See Plumb, *The Tax Benefit Rule Today*, 57 *Harvard Law Review* 129, 130.

The Court then addressed and rejected the State's argument that the tax benefit rule should not be applied without a statutory basis.

We have given careful consideration to the State's insistence that we should not apply the tax benefit rule in the absence of legislative action. Our attention is called to the fact that the Congress of the United States enacted legislation in regard to the tax benefit rule in 1942.

Our research discloses, however, that the adoption of those statutes came about as a result of the fact that the Supreme Court of the United States had never passed on the question and that other federal courts and administrative agencies were far from consistent in their

holdings.

Finally, in deciding the case, the Supreme Court recognized the exclusionary portion of the rule.

As we see it, the question before us is the extent to which tax refunds are taxable as income. The answer to that question, in our opinion, is dependent upon whether or not a taxpayer has gotten a benefit from the refund.

Unless he has received such benefit, there is no reason moral or legal, why the refund should be considered as income.

Since Edelman received no tax benefit from the \$20,000 refund sought to be taxed, the trial court correctly vacated the assessment of the State Department of Revenue. Our holding here is not in conflict with our holding in *State v. Yellow Pine Lumber Co.*, supra. In that case we were not called upon to consider the question as to whether the tax benefit rule should apply. (emphasis added)

In summary, while Edelman involved a tax refund situation, the reasoning of the case indicates that the Court accepted the federal version of the rule in toto and did not intend to limit it to only tax refund situations. As indicated in Home Mutual Insurance Co. v. C.I.R., quoted above, the rule was developed through federal case law to cover a wide variety of situations, and the federal courts have refused to limit the scope of the rule, even after the enactment of §111. There is no authority for limiting its scope in Alabama to tax refund situations only, as the Department has apparently sought to do through Reg. 810-3-14-.04. The exclusionary aspect of the rule should be applied in all instances where there is a recovery of a previously deducted item and the prior deduction provided no tax benefit, as in the present case.

The above considered, it is hereby determined that the tax benefit rule is generally applicable in Alabama, and is specifically applicable to the case at hand. Accordingly, the preliminary assessment in issue is due to be reduced and made final by the Department showing no tax due.

Done this 6th day of May, 1987.

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BILL THOMPSON  
Chief Administrative Law Judge